United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-7619

76-7166

In The

United States Court of Appeals

For The Second Circuit

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Appellants,

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN-AMERICAN BANK and TRUST COMPANY, FRANKLIN NATIONAL BANK and BANKERS TRUST COMPANY,

Appellees.

On Appeal from the United States District Court for the Southern District of New York.

BRIEF FOR APPELLANTS

HAUSER & ROSENBAUM, P.C.
Attorneys for Appellants
350 5th Avenue
New York, New York 10017
(212) 736-7500

9544

LUTZ APPELLATE PRINTERS, INC.
Law and Financial Printing

South River, N.J. (201) 257-6850 | New York, N.Y. (212) 563-2121 | Philadelphia, Pa. (215) 563-5587 | Washington, D.C. (201) 783-7288

TABLE OF CONTENTS

TABLE OF CITATIONS

Cases Cited:

Contents

Contents

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs-Appellants,

-against-

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and BANKERS TRUST COMPANY,

Defendants-Appellees.

BRIEF FOR PLAINTIFFS-APPELLANTS

PRELIMINARY STATEMENT

This is an Appeal from the Order of the HONORABLE MILTON POLLACK, United States District Judge, dismissing the Complaint of the plaintiffs upon Motion of the defendants before Trial and indeed even before issue had been joined. (191a)*. Judge Pollack rescinded his Order of Dismissal as against FEDERAL DEPOSIT INSURANCE CORPORATION for jurisdictional reasons but subsequently plaintiffs discontinued the action as against FEDERAL

*Numbers in parenthesis refer to pages of Appendix

DEPOSIT INSURANCE CORPORATION in order to create a finality so as to permit this Appeal (3a).

Insofar as is known, the Decision or Opinion of Judge Pollack is not reported.

ISSUES PRESENTED TO REVIEW

The primary issues presented for review are as follows:

1. If the plaintiffs acquired their interest in negotiable securities which are the subject of this action as pledgees rather than as purchasers, are they disqualified as a matter of law from invoking the Anti-Fraud Provisions of the Federal Securities Laws to recover their losses where the purchase and the pledge were all part of a simultaneous transaction?

2. Does the prohibition against a Federal Bank lending excessive sums of money to finance the purchase of securities (excess margin) stop short where the securities in question are not registered as required by the Securities Act of 1933, although other securities of the same issuer are indeed so registered?

STATEMENT OF THE CASE

The plaintiffs filed a Complaint (6a-13a) on or about February 24, 1975 (5a) alleging in substance, a Prayer for Declaratory Judgment that they are not liable for the payment of certain obligations originally undertaken to defendant, FRANKLIN NATIONAL BANK, whose right of enforcement had been assigned to defendant EUROPEAN AMERICAN BANK. Their Complaint also attempted to set forth a cause of action for damages as against BANKERS TRUST COMPANY (10a) which plaintiffs desired to amend (187a) so as to allege a claim of violation of the Anti-Fraud Provisions of the Federal Securities Law. Judge Pollack dismissed the Complaint in its entirety holding in effect that the plaintiffs had not and were in any event unable to state any Federal claim whatever (191a).

STATEMENT OF FACTS

Plaintiffs MALLIS and KUPFERMAN are Dentists, unfamiliar with financial matters or with the Regulation of Securities trading and of banking (17a). On March 1, 1972, MALLIS was approached by an attorney, ARNOLD, previously known to him, who urgently inquired as to whether

MALLIS had access to approximately $156,000.00 for immediate use, for a period of thirty (30) days, in order to consummate a purchase of stock. (17a). MALLIS was offered a finder's fee of $50,000.00. The party advancing the money would hold the securities until they could be sold (18a). The securities in question were 40,384 in number (17a), were issued by EQUITY NATIONAL INDUSTRIES INC., whose stock was publicly traded on the American Stock Exchange (120a-127a) and these securities had an aggregate market value at that time of a sum in excess of $400,000.00. MALLIS was also told that these securities though unregistered, could be publicly traded thirty (30) days thereafter through the promulgation by the Securities Exchange Commission of a new Regulation(an apparent reference to the then new Rule 144). The transaction had to be consummated if at all by March 3, 1972.

Amongst others, plaintiff MALLIS contacted his brother-in-law, plaintiff KUPFERMAN. KUPFERMAN discussed the matter with one JOHN MURFITT, an Officer of the FRANKLIN NATIONAL BANK. KUPFERMAN proposed that FRANKLIN NATIONAL BANK advance the funds (18a).

Either on his own initiative or at the request of

one of the plaintiffs, MURFITT investigated the matter in detail, or at least he so stated to the plaintiffs, and he advised them that the proposed transaction appeared regular in all respects, perfectly safe and sound, but that since FRANKLIN NATIONAL BANK knew none of the actors it would go no further than to advance the funds in the form of a loan to the plaintiffs and thus the plaintiffs would be in a position to qualify for the so-called finder's fee (19a). On MURFITT'S absolute assurance of complete safety and that the proposed transaction was in all respects regular, the plaintiffs agreed to participate (19a).

With the sense of urgency instinct throughout, plaintiffs attended at the office of the FRANKLIN NATIONAL BANK on the morning of March 3, 1972 at which time each executed documents by which each in effect borrowed the sum of $78,000.00. The loans were completely unsecured (20a) and when the business of preparing the loan application was complete, MURFITT, FRANKLIN'S officer, told the plaintiffs that he, MURFITT, would see to the disbursement of the funds at the "closing" and that there was no occasion for either of the plaintiffs to attend (20a).

On the same day, March 3, 1972, MURFITT attended a closing at the office of the BANKERS TRUST COMPANY. Present with him were ARNOLD, the attorney who had inter-

ested MALLIS in the transaction in the first instance, KATES, the owner of the securities to be sold together with his attorney; and NATHAN SILVERMAN, an attorney employed by BANKERS TRUST COMPANY (134a,135a). At that time and place there were delivered official checks of the FRANKLIN NATIONAL BANK in the aggregate sum of $156,000.00 (28a-30a) to KATES or BANKERS TRUST COMPANY or both in return for which there was delivered to MURFITT duly endorsed certificates representing the 40,384 shares of the common stock of EQUITY NATIONAL INDUSTRIES INC. (31a-36a). BANKERS TRUST COMPANY received a major share of these funds.

The attention of this Court is urgently invited to the restrictive phraseology contained on the front and reverse sides of each of these certificates: The face of each certificate recites that they are not registered as required by the Securities Act of 1933 (31a-34a); the endorsement side of each certificate contains a legend to the effect that they are subject to the provisions of an escrow agreement and

> "may not be sold, transferred, pledged or hypothecated except in accordance with such escrow agreement" (32a-36a).

No such agreement was presented at the closing.

To put it charitably, the conditions referred to on the reverse side of the certificates in question (32a,36a) as provided in the agreement therein referred to, (222a,275a) had not been complied with (227a-230a) and the securities in question never had a valid issuance or inception (179a). Defendant, BANKERS TRUST COMPANY was on direct notice that the securities in question never had a valid issuance or inception having corresponded with the issuer with respect thereto as early as March 1, 1971 (193a-198a). In addition, at the very time the bank accepted a portion of the $156,000.00 funded as described above, BANKERS TRUST COMPANY was a defendant in an action theretofore commenced by the issuer of the securities in the United States District Court for the Southern District of New York (192a) wherein it was alleged the securities were worthless. None of these facts were disclosed either to the plaintiffs or to anyone else at the closing. Nor did BANKERS TRUST COMPANY disclose that it held judgments against JEROME KATES and his wife for sums in excess of $55,000.00 (282a) or that in fact KATES had enough other judgments against him so that the listing thereof covers eight (8) pages of the Record on Appeal herein (282a-290a).

On this Record, Judge Pollack held as a matter of law that since plaintiffs were not "purchasers" they were

unable in any event to state a claim against BANKERS TRUST COMPANY under the Anti-Fraud Provisions of the Federal Securities Laws (184a-188a) and he likewise denied the request of the plaintiffs that the technical "purchaser", ARNOLD, be joined as an involuntary plaintiff (188a).

Judge Pollack also held that plaintiffs were unable to state a claim for relief as against FRANKLIN NATIONAL BANK or its successor in interest, EUROPEAN AMERICAN BANK, because while Federal Regulations prohibit a Federal Reserve Bank from lending the total amount required to purchase or carry "margin" stock, the stock in question was not "margin" stock within the meaning of the Regulations (180a-184a) because the securities in question were unregistered and consequently fell beyond the reach of Regulation U, which Judge Pollack held to be applicable only to stock registered as required by the Securities Act of 1933.

ARGUMENT

I.

THE HOLDING OF THE DISTRICT COURT THAT PLAINTIFFS ARE NOT PROTECTED BY ANTI-FRAUD PROVISIONS OF THE FEDERAL SECURITIES LAW IS ERRONEOUS

The Lower Court held that the plaintiffs could not invoke the Anti-Fraud Provisions of the Federal Securities

Laws because they were not "purchasers," that they did not "purchase" the securities in question; and that therefore, a claim could not be stated because the same was precluded by the holding of the Supreme Court in Blue Chip Stamps v. Manor Drug Stores, U.S.L.W. 4707, _____U.S. _____(1975) as well as by the holding of the Second Circuit in Birnbaum v. Newport Steel Corp., 193 Fed. 2nd 461, (C.A. 2, 1952) (185a).

Plaintiffs do not quarrel with the holding in either of the cited cases but urge that they simply did not mandate a dismissal of the Complaint of the plaintiffs in this case.

There are at least four reasons why Birnbaum, supra, and Blue Chip, supra, do not apply to the disposition in this case and they will herein be discussed seriatum.

(a) At the outset, it is observed that in Blue Chip, supra, and in Birnbaum, supra, the plaintiffs performed no affirmative act whatever and in that sense they were neither "purchasers" nor "sellers". In Birnbaum, the plaintiffs complained that the value of their stock holdings was adversely affected by the internal machinations of the defendants. In Blue Chip, the plaintiffs claimed that they failed to purchase securities which they otherwise would have purchased but for the overly pessimistic state-

ments concerning the securities in question made by the defendants.

While in Birnbaum and in Blue Chip, the plaintiffs were neither purchasers nor sellers it is equally true that there was neither a purchase nor a sale with respect to which the plaintiffs in either case could make complaint. It is the position of the plaintiffs therefore that at least as important as the characterization of the plaintiff is the characterization of the transaction (or in the case of the Blue Chip and Birnbaum plaintiffs, the non-transaction) from which the claimed damages flowed.

An examination of Vine v. Beneficial Finance Co., 374 Fed. 2nd 627 (C.A. 2 1967) Cert. Den. 389, U.S. 970 88 S. Ct. 463 19 L.Ed. 460 (1967) will serve to clarify the point. The Vine case is closely akin to Birnbaum except that the Vine plaintiffs had reached the impossible point of being required to sell their stock to the perpetrators of a fraud or of being required to accept an appraisal value of the stock which would be equally inadequate since the stock had theretofore been fraudulently depreciated in value. The Vine plaintiffs were required to act affirmatively in one way or another to dispose of their stock holdings and the Second Circuit the case to be distinguishable from Birnbaum where the plaintiffs were not required

to do anything. In the instant case, although the plaintiffs were not required to do anything they in fact provided the impetus for the entire sale of stock by KATES to others. There was no lack of action; there was a purchase and a sale. Rule 10 (b)(5) has as its predicate the requirement that certain acts are unlawful if:

> "Committed in connection with the purchase or sale of any security."

As above demonstrated, neither the Birnbaum nor Blue Chip plaintiffs could point to any purchase or sale of securities in which they were the direct actors. On the contrary it was their inaction which required that their complaints be dismissed.

Superintendent of Insurance v. Bankers Life &Casualty Co., 404 U.S. 6 1971 is likewise instructive. There, the assets of the plaintiffs'predecessor in interest were used to purchase its outstanding stock. In a literal, academic or technical sense, the plaintiffs' predecessor was neither a purchaser or seller of securities. However, as with the plaintiffs in this case, its creditors were injured "in connection with the purchase or sale" of the securities in question. The Court held that the plaintiff had standing to sue stating at Page 12:

> "Section 10 (b) must be read flexibly, not technically and restrictively. Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there

> is redress under §10 (b), whatever might be available as a remedy under State law.
>
> We agree that Congress by §10 (b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement. But we read §10 (b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face. And the fact that creditors of the defrauded corporate buyer or seller of securities may be the ultimate victims does not warrant disregard of the corporate entity."

In an intellectual or technical sense, the plaintiff in Superintendent of Insurance, supra was neither a purchaser nor seller of securities but the interests represented thereby suffered injury "in connection with" the purchase and sale of such securities. Likewise, with the plaintiffs.

(b) Moreover, whatever was the plaintiffs' conception of the basis of their participation in the transaction it is by no means plain that they were not in fact purchasers. ARNOLD, who might be described as the purchaser of record testified under oath that in consummating the purchase he acted in behalf of MALLIS (216a). In this connection, See the quotation from Goldberg, Private Placement And Restricted Securities infra, Page 14.

(c) The plaintiffs requested the opportunity to join the "purchasers of record" as involuntary parties plaintiff pursuant to Rule 19 of the Federal Rules of Civil Procedure (208a-210a). Had this been permitted the overly restrictive reading by the District Court of the Birnbaum and Blue Chip decisions could have been preserved while at the same time giving to the plaintiffs the opportunity to recoup their losses. The District Judge denied that request for relief (188a-189a).

(d) Finally, there does not appear to have been any case which carefully considered whether a pledgee of negotiable securities who becomes such simultaneously with the purchase thereof by another may invoke the Anti-Fraud Provisions of the Federal Securities Laws. The most elementary principles of Justice would seem to mandate a holding that a pledgee so situated has at least as much cause to complain of a fraud as does the purchaser whose purchase he furnishes the consideration for. The purchase of stock, particularly in large blocs often involves a consortium of some sort, such as an aggregation of capital by a group or by a loan of funds to a purchaser.

In Goldberg, Private Placement and Restricted Securities, §2.3 [f] [5], it is stated:

> "As with the issuance of warrants and options the creation of a pledgee's interest in a security will expand the scope of an offering. The pledge will be considered an additional purchaser with the effect of enlarging the scope of the offering. Resale by the pledgee, brought about as a result of the pledgor's default in repaying his loan, will further expand the scope of the original offering.
>
> Analogous to the creation of a pledgee's interest in his collateral is the agreement to share profits on the appreciation of a security in return for a loan of the portion of the purchase price of the security. In such cases both the purchaser of record and the person or persons advancing the funds in reliance upon the profit sharing agreement are considered purchasers for the purpose of computing the scope of an offering."

The Second Circuit has apparently not passed upon the standing of a pledgee of stock to complain of a fraud in the inducement of the sale thereof. In Dopp v. Franklin National Bank, 461 Fed. 2nd, 873 (C.A. 1973), the Court considered the standing of a pledgor to complain of a stock fraud and assumed that such standing existed. In behalf of the plaintiffs it is urged that the pledgee, who normally furnishes the consideration for such purchase, should have such standing.

Nor does the grant of Summary Judgment to the Bankers Trust Co. in the State Court preclude the maintenance of this action. It will be observed that Bankers Trust Co. moved for dismissal of the action in the State Court on the authority of CPLR 3211 (a)(7) (131a). Such a motion is addressed to the sufficiency of the pleading presented by the plaintiff to the Supreme Court. That Court held the allegation of the complaint to be legally insufficient. The dismissal was not on the merits. CPLR 5013 provides that a Judgment of Dismissal of a complaint before the close of the evidence is not on the merits. Consequently, since the plaintiffs never presented any evidence in the State Court, (or indeed in the District Court), the dismissal of the complaint as a complaint does not preclude the maintenance of this action against Bankers Trust Company. Moreover, the ruling case law of the State of New York is that the doctrine of res judicata or estoppel does not apply to a dismissal in a fraud case where the dismissal was obtained as part of the fraud. See, e.g., Burbrooke Manufacturing Co. Inc., v. St. George Textile Corp., 283 App. Div. 640 (A.D. 1 1954). In any event the Second Circuit has held that the Anti-Fraud Provisions of the Federal Securities Laws cannot be subverted to Judgments entered in the State Courts between identical parties. Pearlstein v. Scudder and German, 429 Fed. 2nd

1136 (C.A. 2, 1970) Cert. Den., 401 U.S. 1013 (1971).

II

THE SECURITIES IN QUESTION MAY BE DEEMED TO BE "MARGIN STOCK" WITHIN THE MEANING OF REGULATION U.

Federal Regulations require that the aggregate of monies borrowed for the purpose of purchasing or carrying "margin stock" may not exceed a percentage of the entire purchase price. The percentage which may be borrowed for this purpose is varied from time to time by the Board of Governors of the Federal Reserve System. These federal requirements are spelled out in Regulation U of the Federal Reserve Regulations (12 C.F.R. §221.1 et. seq.) as to banks and in other Regulations promulgated by the Board of Governors as to others. Their object was to limit and restrict the flow of dollars into the purchase of securities, except by those who own the dollars. It is by now well established that a violation of these regulations gives rise to an implied cause of action or right of rescission on the part of the recipient of funds advanced by one prohibited by the Regulations from making the advance.

Serzysko v. Chase Manhattan Bank, 290 Fed. Supp. 74 (S.D.N.Y. 1968), Aff'd. 409 Fed. 2nd 1360 (2 Cir. 1969.

Goldman v. Bank of Commonwealth, 467 Fed. 2nd 439 (6 Cir. 1972).

It is the position of the plaintiffs that FRANKLIN NATIONAL BANK violated the margin regulations by advancing 100% of the funds required for these plaintiffs to purchase or carry the securities in question and that consequently they may rescind the obligation of repayment to FRANKLIN NATIONAL BANK and its successor, EUROPEAN AMERICAN BANK.

The District Court held that Regulation U did not apply because the stock was not "margin stock" within the definition of the term as it is defined in the Regulation. (See Regulation U, 12 C.F.R. 221.3 (v)). The Regulation defines "margin stock" as any stock which is:

> "(1) A stock registered on a National Securities Exchange***
>
> (3) A debt security (i) convertible with or without consideration presently or in the future into a margin stock***
>
> (4) Any such warrant or right."

The District Court held that it was arguable whether the stock in question was "registered on a National Securities Exchange" (181a) since other securities of the issuer were in fact regularly traded on the American Stock Exchange. However, the District Court held that the quoted

language did not apply because the particular securities acquired by plaintiffs were not registered.

In this connection, the Court's attention is invited to a Letter of Opinion dated May 30, 1975 from the Board of Governors of the Federal Reserve System (206a). The opinion there expressed is that those securities not registered as required by the Securities Act of 1933 are margin stock within the meaning of Regulation U if other securities of the same class issued by the issuer are traded on a National Exchange.

Moreover, if plaintiffs were merely lenders, then the securities in question are "a debt security convertible with or without consideration...into a margin stock" within the meaning of the Regulation above quoted. It is evident that Rule 144 of the Rules and Regulations of the Securities and Exchange Commission was the intended vehicle by which it was expected that the securities in question would be disposed of. Certainly, if the securities in question were salable under the authority of Rule 144, then they would be salable on a National Security Exchange and at least by that time they would have become "margin stock" since, on this hypothesis, the securities were received by the plaintiffs as security for a debt. It

would seem that, in the circumstances here presented, the plaintiffs acquired "margin stock" as a debt security within the meaning of the definitional provisions of the term as employed in Regulation U.

CONCLUSION

In behalf of the plaintiffs it is urged that the dismissal of the complaint be reversed so that a fuller opportunity to explore the facts and the law may be had.

Respectfully submitted,

HAUSER & ROSENBAUM, P.C.
Attorneys for Plaintiffs-
Appellants

A 202 Affidavit of Personal Service of Papers
COURT OF APPEALS
FOR THE SECOND CIRCUIT

LUTZ APPELLATE PRINTERS, INC.

SAMUEL MALLIS AND FRANKLIN HUPFERMAN,
Appellamts,

- against -

FEDERAL DEPOSIT INSURANCE CORP. et al.,
Appellees.

Index No.

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF NEW YORK *ss.:*

I, Reuben A. Shearer *being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age and resides at* 211 West 144th Street, New York, New York 10030

That on the 18th *day of* May *19*76 *at* see attached

deponent served the annexed ~~Appendix~~ Brief *upon*

see attached

the Attorneys *in this action by delivering a true copy thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the herein,*

Sworn to before me, this 18th *day of* May *19*76

Reuben Shearer

Reuben Shearer

ROBERT F. BRIN
NOTARY PUBLIC, State of New York
No. 31-0418950
Qualified in New York County
Commission Expires March 30, 1977

Hughes Hubbard & Reed
Attorneys for Defendant Federal Deposit Ins. Corp.
One Wall Street
New York, New York 10005

Sullivan & Cromwell
Attorneys for Defendant European American Bank & Trust Co.
48 Wall Street
New York, New York 10005

Charles Leeds
Attorney for Bankers Trust Co.
1775 Broadway
New York, New York 10019